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Development Finance in the age of Financial Mercantilism.

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Abstract

On September 2015 the UN General Assembly approved a resolution sometimes called Agenda 2030, with 17 Sustainable Development Goals, SDGs, to be attained by 2030. The achievement of the SDGs could require hundreds of trillion dollars. Financial flows to developing have greatly increased since 2000, in particular Foreign Direct Investments and remittances, but also Portfolio flows. A lot of the money seems to be available in financial market.

However today international finance is characterized by Financial Mercantilism, FM. There are many similarities between the operation of the seventeen century merchants and today financial intermediaries. Resorting to notions derived from history of economic ideas the paper identifies the elements which characterize FM and which portray the role of finance in the present phase of the capitalist system. Financial Mercantilism is not the ideal setting for long-term development finance and to channel funds towards developing countries, which could be hurt by a the debt crisis similar to that experienced in the eighties.

The paper shows how to mitigate the possible negative impacts of Financial Mercantilism on development finance. Policy recommendations are hinted in the conclusive part of the paper. Financing for development cannot be left to international financial markets, but it requires some specific tools and instruments. The paper briefly discusses the case of indexed bonds and contends that development finance should take place on separate markets.

It is a long paper and the reader might wish to focus on some issues. If you are interested on Financial Mercantilism go to sections 3 and 4. If you are interested on financing for development focus on sections 5 and 6. The index will help.

Section 1 deals with the means of financing needs the Sustainable Development Goals and with the problem of how to finance developing countries Section 2 examines the lessons which could have be drawn from the debt of the eighties. Section 3 examines the evolution in of international finance since the seventies while in section 4 there is an analysis of the main features of Financial Mercantilism. Section 5 examines the role of sovereign bonds in development finance and section 6 presents three proposals to make development finance more sustainable and more equitable.

[1] A former version of the paper has been presented in a session of the STOREP Annual Conference "Investments, Finance, and Instability", Piacenza, June 8-10, 2017. I thank all the participants to the session. All responsibility is mine.

Development Finance in the age of Financial Mercantilism

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University of Pavia, May 2018

Prologue

On July 2014 a 'vulture' fund Themis Capital and Des Moines won a case against the Democratic Republic of Congo which should now repay 18 million dollars of an original debt plus 70 million as interest(The Financial Times, 27th November, 2014). The debt had been contracted in the early 1980s by Mobutu, but Themis Capital was not among the original creditors, it bought Congo's debt years later at huge discount on face value, but now should be repaid at full nominal value. Congo has an income per capita of 430 dollars, 71.3 per cent of the population below the national poverty line and most of its people were not born when the debt was contracted.

Index

1. Financing the Sustainable Development Goals

1.1 Financial flows towards developing countries

1.2. Different resources for different goals and countries

2. Developing countries' foreign debt crisis

2.1 The 'lost decades'

2.2 Lessons from the crisis?

3. International finance

3.1 Booming international financial markets

3.2 'Secular stagnation' and three paradoxes

4. Financial Mercantilism

4.1.The 'balance of trade' doctrine

4.2 Modern Mercantilism

4.3. The M-M' conundrum

4.4. The concentration of power

5. Developing Countries Sovereign Bonds

6. Sustainable Financing for Development

6.1. Entering international financial markets in a gradual way

6.2. Indexed bonds

6.3. Separate markets for the bonds of low income countries

Conclusions

References

1.Financing the Sustainable Development Goals

1.1 Financial flows towards developing countries

On September 25th 2015 the United Nations General Assembly passed a resolution including the new Sustainable Development Goals, SDGs, sometime called Agenda 2030(see UN-GA 2015). The seventeen goals include 169 targets and 241 indicators were added on March 2016(see UN ECOSOC 2016), the goals should be achieved by 2030.

With so many goals and targets the amount of financial means to implement all of them is enormous. The 2015 European Report on Development suggests tens of trillion of dollars needed on infrastructures and energy only(see European Report on Development 2015 pp. 73-ff.). Not all of these funds might be needed by developing countries; many goals should be of primary concern for high income and emerging economies in particular. Many goals are related to environmental issues and they should see the rich and large emerging countries at the forefront: these goals have been at the core of the Cop21 conference on climate change which took place in Paris in December 2015. At least nine of the seventeen goals focus on climate actions designed to save energy and to change the current use of natural resources, from rainforest to the oceans.

However low income countries too should pursue the goals in which environmental sustainability has a leading role; think of the challenges represented by infrastructures, clean water, sanitation and big cities in a low income country. On top of these developing countries still face some ‘traditional’goals such as poverty, hunger, health and education, which were already part of the 2000 Millenium Development Goals. To address all these challenges developing countries will probably need trillion of dollars in the coming decade and the question is where to find these funds and how to channel them where they are most needed. In 2014 the UN has produced a Report of the Intergovernmental Committee of Experts on Sustainable Development Financing(see UN-ICESDF (2014) and in July 2015 in Addis Ababa there was the Third International Conference on Financing for Development(see UN-AAAA 2015).[2]

Even if the overall quantity of funds might be short of what would be needed there will probably be a lot of funds potentially flowing towards developing countries, thanks in particular to the huge

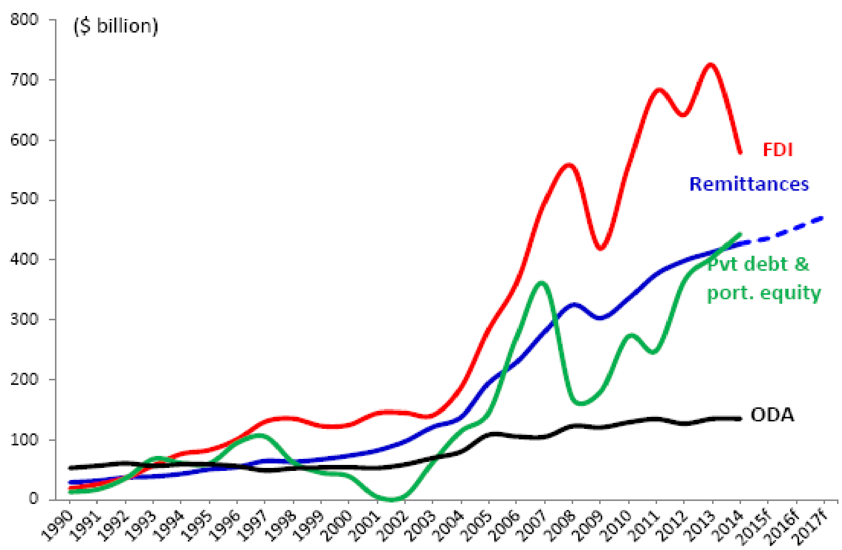
[2]This problem has been widely discussed since the first UN conference on Financing for Development in 2002 in Monterrey, which has been followed by a similar conference in 2008 in Doha.

increase in private funds, in particular since the year 2000. Figure 1 describes the major flows to developing countries.

With respect to the nineties the situation has completely change. Official Development Assistance, ODA, international aid was the most relevant item, now is lagging behind private flows. The figures include flows towards upper middle income countries, the so called emerging markets, including Asian and Latin American ones where FDIs play a major role.

Figure 1. Total net resource flows to developing countries, by type of flow.

(Billion of Dollars)



Sources: World Bank Staff calculations, World Development Indicators, OECD. Private debt includes international bonds and borrowing through commercial banks.

Following the financial crisis of 2008 FDIs and Portfolio flows have become very volatile, while remittances are much more stable.[3] For low income countries the picture is slightly different, up to the year 2000 Official Aid was the largest flow to Africa. In 2010 ODA was in the third place

[3] The figure include only officially recorded remittances; informal remittances could be also extremely high. Remittances play and anti-cyclical role: they tend to increase after crises and natural disasters.

behind Foreign Direct Investments and remittances. In the case of African countries net portfolio flows were very small and highly fluctuating and they became negative following the 2008 financial crisis.

The good thing is that a lot of money pours towards developing countries, including private funds, but in order to assess how far these different types of funds could be used to achieve the SDGs some further considerations are necessary.

1.2. Different resources for different goals and countries

The 2015 European Report on Development states that the way in which finance will be mobilized and directed to the different SDGs is more important than the overall availability of funds(see European Report on Development 2015, pp. 27, 323). The issue is the composition of different financial means with respect to both the type of needs, the goals, and above all the type of countries. Let us briefly summarize the state of the issue.

Developing countries should try to rely more and more on **domestic resources**(see also Touray 2014), both on private and on public ones, namely taxes. However in developing countries the tax base and the tax revenue increase rather slowly, while ODA and Other Official Flows may decrease more rapidly. There is a possible time mismatch between the ability to raise enough domestic resources and the way in which donors disengage from providing these countries with concessional flows. This creates the problem of the so called 'missing middle'(see Kharas et al. 2014, pp. 26-7).

First, different types of financial instruments are needed for **different goals/targets**; Kharas et al. provide a classification of the different types of finance for the different development goals(see Kharas et al. 2014, p. 7.), see also the report of the experts on sustainable development financing(see UN-ICESDF 2014, pp. 8, 18).[4]

One important issue has to do with the so called Public Private Partnership, PPP; which has to provide the appropriate mix between incentives for private funds and the coherence with respect to the SDGs and to the country's priorities. PPP is seen a very powerful new tool to increase foreign financing, in particular when public funds, ODA, is used to 'leverage' more private funds.[5] This can

[4] The 2015 European Report on Development highlights some new types of financing for development(see European Report on Development 2015, pp. 123-125). The report introduces the notion of 'enablers' of sustainable development (see ibid. chapter 6 and pp. 298-299).

[5] The use of public funds in order to raise private funds could also expose the receiving country to the risk of more volatility.

be a very important tool in particular in the case of funds dedicated to special goals and purposes. The typical case is the Global Fund to combat HIV, malaria and other diseases. Energy and infrastructures are two other areas which could be interesting to private investments. But in the end FDIs depend on the strategic decisions by transnational companies.

Second, different financial opportunities depend also on **different income levels** of the countries(see European Report on Development 2015, pp. 299-300, 315 and Kharas et al. 2014, p. 27). FDIs move mainly towards Middle Income Countries and much less towards Low Income ones.

Remittances are the second largest type of flow; they also go to low income countries and they typically move from people to people.[6] Remittances can certainly contribute a lot to goals such as education, housing, sanitation, but that will largely depend on decisions taken by local households.[7] Moreover we tend to think of remittances as money flowing from rich to poor countries, but less than 40 per cent of overall remittances flows from 'North' to 'South', around 35 per cent of recorded remittances imply money flowing among developing countries.[8] Many LDCs and LICs receive a lot of remittances in proportion to GDP and this help to compensate for the negative current accounts(see Capelli and Vaggi 2014).[9] This is also the case in some LMICs.

Third, another obvious way to classify the different types of FfD is the **degree of concessionality**, which partly overlaps with the classification according to different income levels. A combination of types of need, income levels and degree of concessionality is also in UN-ICESDF 2014, p. 31. ODA and *grants* in particular are the preferred type of resources for LDCs and LICs, and for human and social type of needs, such health and WASH, Water Sanitation and Hygiene.

Fourth, there is a large consensus that Least Developed and Low Income Countries should go through **a process of graduation**: from receiving from concessional flows only at some point they

[6] Recorded remittances can be as high as 45 per cent of GDP in some small countries, but even in some large countries such as Bangladesh, Pakistan and the Philippines they are around 10 per cent of GDP(see Capelli and Vaggi 2016).

[7] Of course remittances depend upon the lack of job opportunities in many developing countries

[8] The overall number of migrants is in the range of 250 million people, of which around 200 million from developing countries. The SDGs dedicate very little space to the issue of migrations, there are: point 29 of UN-GA 2015 Resolution, target 8.3 on how to protect labour rights including migrant workers; target 10.7 on responsible migrations and target 10.c. on the reduction of the cost of remittances.

[9] In many MICs and resource rich countries FDI generate the problem of profit repatriation which of course has a negative impact on the current account (see Capelli and Vaggi 2016). Portfolio flows too might have negative effect of on growth, because of possible negative shocks (see European Report on Development 2015 p.154).

should be able to access of international financial markets. Ideally development finance should help the receiving countries to move along a path which starts with grants, then moves on to concessional loans, then to blended finance and finally to private financial markets.

LDCs and LICs should make maximum use of *not-fully market instruments for development finance* and the whole process should be gradual and carefully monitored. In practice it might be very difficult to strictly follow this path.

In this process of graduation an important role can be played by Multilateral Development Banks, such as the regional banks AfDB, ADB. The new so called BRICS Development Bank(see Griffith Jones)[10] and the Asian Infrastructure Investment Bank (AIIB) could also support this process of graduation, in particular taking care of infrastructural projects in LDCs and LICs.

2.Developing countries' foreign debt crisis

2.1 The 'lost decades'

The issue of 'graduation' of LDCs and LMICs poses the problem of how to avoid the major financial crises that in the past had a terrible impacts on developing countries. Since the eighties developing countries have experienced repeated *major financial crises*, we recall just the major ones:

-the debt crisis which started in august 1982 with Mexico's default,

-Mexico's second default in December 1994,

-the Asian Crisis of 1997-1998,

-Russia, Turkey, South Africa, Brazil in 1998-99,

-Argentina in December 2001, with problems again for Turkey and South Africa.

In some cases currency depreciation led to improvements in the external account and to economic growth. The most successful case has been South Korea in 1997-98; a 45 per cent depreciation of the won between November 1997 and April 1998 and a minus 8 per cent of the GDP in 1998, were followed by a growth rate in the range of 5 per cent in 1999, only slightly lower than before the

[10] Innovative ways to mobilize resources could also help countries in this phase of transition towards international financial markets. The OECD 2014 Development Cooperation Report puts forward the idea of 'peace bonds' to finance peace initiatives.

crisis. By the end of 1999 Korea was already paying back the money received by the IMF[11]. It was a typical *V crisis*, a deep but a short one.

More than 30 countries were involved the 1982 debt crises including some European countries, such as Portugal, Poland and Hungary and some Asian countries which have then become high income economies such as South Korea.[12] Following the outbreak of the crisis income per capita did not improve for more than ten years many countries in Sub-Saharan Africa, Middle East and North Africa and in Latin America. It was the period of the so called 'lost decade', but in fact the impact on the real economies went on until the late nineties.[13]

A reasonable solution to the crisis emerged only with the Heavily Indebted Poor Countries Initiative, HIPC, which was first proposed in 1996. For the first time this plan implied some type of debt cancellation. After fourteen years from the outbreak of the crisis this initiative, at last, was taking into account the fact that most of the foreign debt of these countries and in particular of the weakest African ones, was due to arrears on previous payments and that these countries were not able to repay. Thanks to a large advocacy activity under the umbrella of the Jubilee 2000 campaign the HIPC initiative was strengthened at the Koln G7 of 1999 it was implemented in the first part of the 2000s. Unfortunately the procedures to obtain the partial cancellation of foreign debts were very cumbersome and could take as long as six years.

In 2005 and the World Bank and the IMF added the Multilateral Debt Relief Initiative, MDRI, which also implied debt cancellation. Debt cancellation has been very effective in improving the debt sustainability conditions of these countries. However the improvements in the various debt ratios are largely concentrated in the early 2000s and they are the direct outcome of the cancellations of foreign debts. Following the initial reductions both the debt to GNI ratios and the debt service ratios have stabilized without any further improvements.

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[11] Following the 1997-98 crisis in South Korea investments went down 10 per cent point of the GDP, from 35 to 25 per cent. Malaysia, Thailand and the Philippines followed similar patterns, in Indonesia the crisis was much deeper and longer(see Vaggi 2002).

[12] The countries hit by the debt crisis of the eighties were: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, Venezuela, Costa Rica, Jamaica, Cote d'Ivoire, Nigeria, Sudan, Yugoslavia, Poland, Hungary, Turkey, Algeria, Egypt, Morocco, Bangladesh, India, Pakistan, The Philippines, South Korea, Indonesia, Malaysia, Thailand, Portugal(see Vaggi 1993).

[13] In Sub Saharan Africa average GNP per capita was US$ 680 in 1984 and US$ 480 in 1998(see World Bank, *World Development Report 1986* and 1999/*2000*).

All crises were characterized by previous large capital inflows because of the higher returns on offered by portfolio investments and loans to developing countries. Today we are again in a situation in which a lot of funds are available on international financial markets and very large investments are needed to try to accomplish the goals of Agenda 2030. The risk is that the money flowing towards low and lower middle income countries could lead to a replay of the negative experiences of the eighties and nineties. After some quiet years in 2015 Puerto Rico has had major sustainability problems on her external debt and has then defaulted. Since 2016 Mozambique is getting into serious repayment troubles. Another debt crisis cannot be ruled out, in particular in the Least Developed Countries(see Eurodad 2014 p. 16).[14]

2.2 Lessons from the crisis?

The main lesson from the various financial crises is that the ability of a country to react to a crisis depends upon its productive and trade structure. Capital outflows are difficult to resist and can easily lead to exchange rate devaluation; which can restore international competitiveness and improve the trade and the current account and hopefully restart a process of economic growth. However this positive outcomes can only materialize if the country has the capacity to produce and to sell products which are in high demand on international markets. The 1997 devaluation worked in South Korea because her export composition was such that it could take advantage of price competitiveness in the production of commodities which were, and still are, very much in demand.

Most countries in Sub Saharan Africa have structurally negative trade and current accounts and they are still building foreign debt.[15] During the period 2000-2015 45 out of 48 countries in Sub Saharan Africa had a deficit in the Current Account and for 14 countries the deficit was larger than 10 per cent of the GDP.[16] Without an extensive transformation in their productive structure even commodity exporters are exposed to huge risk of insolvency.[17]

[14] Griffith Jones and Tyson 2012 find many similarities between some African countries today and Latin America and Asia in the eighties and nineties respectively.

[15] On the difficulties of Low Income Countries to be able to regularly service foreign debt see also Vaggi 2002a.

[16] The situation has not improved much since the eighties and nineties. Between 1980 and 1998 the 28 HIPC countries which benefited from debt cancellation had current account deficits for all the years but one.

[17] Greece faces a similar challenge, even if it should leave the Eurozone it is doubtful that there could be any major improvement in her current account, her productive structure and her export composition is very weak in terms of tradable goods and services.

The ability of an economy to graduate from concessional funds and to finance its goals through private international markets is linked to its capacity to avoid major current account crises, a kind of *resilience* to external macroeconomic and financial shocks. This *resilience* depends on the structure of both GDP and export.

Two more considerations should be added to the issue of the appropriate type of development finance for different types of countries that we have seen in section 1.2 above.

First, it would be useful to classify the different financial resources also according to two other features:

- whether the resources are ***short/long term*** and
- whether or not developing countries can ***lock-in*** these flows.

The latter feature is particularly important and it refers to the possibility of the receiving country to have some control on the destination of the funds and on the possibility to control that they could stay in the country long enough to achieve the desired goals.

Second, a new criterion should supplement the traditional *classification of countries* according to income per capita: the ***productive structure*** and the ***export capacity of a country.*** Tezanos Vàzquez and Sumner group developing countries according to four dimensions of development which lead to five clusters(see Tezanos Vazquez and Sumner 2013, pp. 1733, 1737-8). The first development dimension they identify is: "development as structural transformation" which includes GDP and export composition.[18]

This classification overlaps with the classification in terms of income levels; in general Middle Income economies have stronger productive capacity than LDCs. However in the past many MICs had serious problems with foreign debts and even recently some emerging economies, and even BRICS, experienced problems in international financial markets; Argentina, South Africa, Brazil and Turkey are typical cases of countries which might easily slip into current account problems. Many LMICs and also UMICs have not yet fully recovered from the debt crisis of the eighties (see UN-ICESDF 2014, p. 7), and interest payments, though not as heavy as in the late nineties, do contribute to worsen the current account.

[18] Nielsen classifies countries in a different way(see Nielsen 2013, pp. 1093-96).

Financing for Development needs a country specific approach(see Kharas et al. 2014, p. 17). This is the only realistic possibility because of the different conditions of each country with respect to income and human development levels, economic structure and so on.[19]

3. International finance

All those crises have taught useful lessons, but we need to try to understand better the type of economic and financial environment in which Financing for Development has to be implemented.

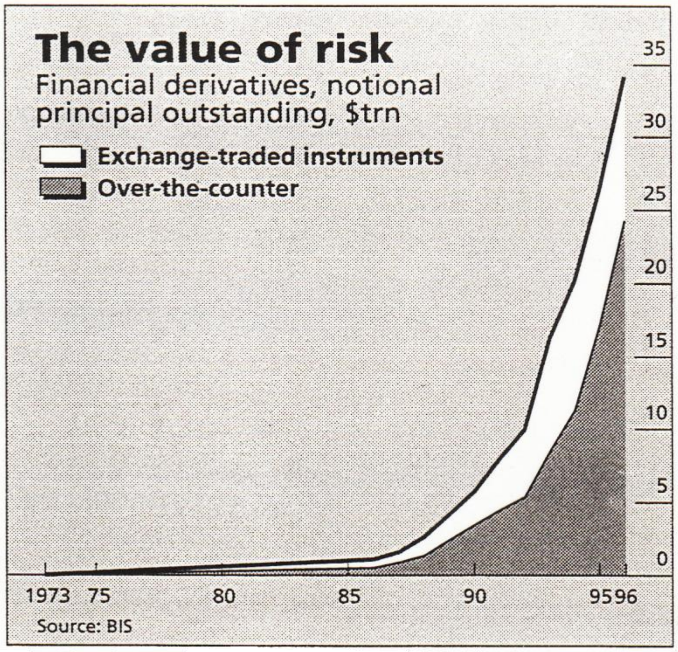
3.1 Booming international financial markets

In 1985 the overall notional value of financial derivatives was slightly more than 1 trillion dollar, in 2007, at the beginning of US the sub-prime crisis, overtook 600 trillion; 11 years later it is still an amount almost nine times larger than the world GDP.

The massive increase of international finance dates back to the end of the Bretton Woods system and to the financial liberalization which has taken place since the early eighties. On 15th August 1971 Richard Nixon "closed the gold window" and the world of international finance was changed forever. The dollar floated and the foreign exchange risk was privatised. The ratio of currency trading to international trade in goods and services plus long term investment rose from 2 to 1 in the mid seventies to 80 to 1 in the late nineties. Under the Bretton Woods system bond issuances was largely limited to domestic markets, but since 1971 entered more and more the international markets. Overseas sales of US bonds rose from 3% of US GDP in 1970 to 150% in the mid-1990s. Overseas sales of UK bonds rose from nil in 1970 to 1000% of GDP in the mid-1990s. The derivative markets had been there for many years but figure 2 shows the impressive transformation which took place in international finance during the eighties.

[19] The UN group of experts on development finance mentions the need of securing country ownership in the design and implementation of policies and in the financing strategies(see UN-ICESDF 2014, pp. 8, 18).

Figure 2. The exponential growth of finance (Source: *The Economist* and BIS)



Hyman Minsky foresaw the potential damages of uncontrolled finance in neat way and recognized that the world of finance is characterized by ***systemic risk***. His contributions date back to the mid-seventies when the overall market for derivatives was still puny and the consequences of the abandonment of some of the Bretton Woods pillars were not yet evident(see Minsky 1974 and 1975). Financial markets are characterized by periods of price increases, bubbles which at some point burst and lead to major crises.

Developing countries suffered many crises, but the new dimension of international financial markets had also a major impact on high income countries.[20] In September 1992 international speculation forced Italy, Spain and the UK to devalue their currencies versus the German mark. Foreign exchange reserves at the three central banks were not sufficient to defend the value of the Italian lira, of the British pound and of the Spanish peseta. Reserves are a typical tool devised to defend the currency from speculative attacks particularly in a system of fixed exchange rate as the Bretton Woods dollar exchange standard was. In 1977 the value of global official reserves was fifteen times larger than the daily transactions on foreign exchange markets but by 1992 this number was less

[20] One could also recall the dot com bubble of 1998-2001 and the 1998 collapse of the Long Term Capital Management, LTCM.

than 2; the three central banks had less ‘ammunitions’ than those available to international speculators.

Fifteen years later in 2007 there has been another major crisis which originated in the US sub-prime mortgages market and then spread to Europe. The crisis is not yet completely over and its impact on long term growth is still not clear. Since 2008 economic growth has been quite weak in many High Income Economies notwithstanding the expansionary monetary policies adopted by the central banks. The Federal Reserve, the Central Banks of England and of Japan and the European Central Bank intervened with a variety of tools. First of all they aimed at saving some ailing banks, but not Lehman Brothers, and then they poured a lot of money into the economy, the various forms of Quantitative Easing. Interest rates have been very low for many years.

3.2 ‘Secular stagnation’ and three paradoxes

The sluggish economic growth has led to a debate about the so called *secular stagnation*, following Larry Summers’ reappraisal of this term. Many explanations of this phenomenon focus on the relationship between savings and investment and the fact that due to an excess of savings the real interest rate needed to equate investments and savings at full employment level may be negative.[21] This means that monetary policy becomes ineffective because due to low inflation and low nominal rates there is a floor, the so called Zero Bound Level, ZBL, for nominal rates which makes it impossible to reach negative rates(see Baldwin and Teulings, 2014, p. 2). To put it in Keynesian terms it is as if the liquidity trap had become a long run feature of the economy(see Krugman in Baldwin and Teulings, 2014, p.15). Major explanations for the increase in savings are related to demographic reasons and to an increase in life expectancy combined with lower population growth rate, the so called “ageing society”(ibid. pp. 11-12, 14)[22].

It should be noted that the decline of growth rate of High Income Economies is not a recent phenomenon, the growth rate has been continuously decreasing since the sixties. Between 1961 and 1970 the average growth rate was higher than 5 per cent, it went down to less 4 per cent in the seventies and eighties, during the nineties it stayed around 3 per cent, decreased again to less than 2 per cent between 2001 and 2015.

[21] On the various explanations for secular stagnation see Baldwin and Teulings, 2014. Backhouse Boianovsky(2016) provide an history of the origin of the debate.

[22] These phenomena lead to an increase in the dependency ratio because of the raising share of retired people; an older population requires more savings.

Most likely there are other reasons for the sluggish economic growth in rich countries, but let us go back to the abundance of savings; this leads to ***three paradoxes***.

Paradox 1, in the 1939 Harrod's growth model a higher saving ratio, s= S/Y, leads to a higher warranted growth rate. In the neoclassical version of the model as presented by Solow in 1956 a higher s implies a higher income per capita in the steady state, provided S=I.[23] Now it seems that savings are the problem and might cause a growth slowdown.

Paradox 2, the three countries/areas which are saving more are China, continental Europe and Japan, the one which saves less is the US however the economy is growing faster in the US than in both Europe and Japan(see Blanchard, Furceri and Pescatori 2014 p. 104).

The 'savings glut' and demography are not sufficient elements to explain the low growth rates in high income economies; it could be useful to look for a combination of both supply and demand type of causes. There is a need for huge investments in particular in infrastructures in both high income economies and in developing countries(see Caballero R.J. and Farhi E. 2014, pp. 118-119).

But what is the role of international financial markets? They should favour a better *allocation of resources* at the world level. The easier to move capitals across border the better, larger set of financial investment opportunities should help to allocate capital in the most efficient way. Financial markets should bring savings where they are lacking and hence most needed and were they can also generate higher returns. All this derives from the so called 'market efficiency hypothesis'. International financial markets should help to increase the average world growth rate and to speed up the closing of the gap between low and high income economies; however there are serious doubts that more finance implies more growth(see for instance Arcand *et al* 2012). As Hélène Rey, writes "it is hard to ascertain or measure the real gains from financial openness and freely moving capital….trillions of dollars have crossed borders, and yet despite our best efforts and hundreds of studies, it has been extraordinarily difficult for economists to identify any benefits from these flows"(Rey 2015, p. 6).

Paradox 3. East-Asian economic growth is largely explained by a combination of export–led growth, industrial policies and huge accumulation of physical capital. Capital accumulation has largely relied on domestic savings with investment ratios in the order of 25-30 per cent since the sixties; China has reached 45 per cent in 2009-2010. Not only these investments are obviously long-

[23] According to Solow's model capital should flow to low and middle income economies due to their higher profitability, as measured by the marginal productivity of physical capital.

term, but they are largely based on self-financing by firms through reinvested profits. In the Japanese and Korean experience there has been a fundamental profit-investment nexus(see UNCTAD 1996) which has by passed International Financial Markets[24].

4. Financial Mercantilism

4.1.The 'balance of trade' doctrine.

"….we must observe this rule; to sell more to strangers yearly than we consume of theirs in value."(Mun 1623?, p. 5). Mun goes on defending the role of trade with the *East-indies* (ibid. p. 7).

Thomas Mun was a director of the East India Company and the father of the mature phase of Mercantilism, characterized by the so called *balance of trade* Theory, according to which a surplus in foreign trade is the main cause of national wealth. It is thanks to this surplus that precious metals flow into the country's coffers. Of course not all countries can run a trade surplus at the same time; Mercantilism is a zero-sum-game which leads the nation states to protectionist interventions; the 'beggar thy neighbour' policies.

Adam Smith identifies two major problems with Mercantilism.

A *first problem* concerns the fact that Mercantilism subvert the 'natural order' of investments. In chapter v of Book II of the *Wealth of Nations* Smith capitals should first be invested in agriculture in order to secure an agricultural surplus and then they should move on to the manufacturing sector, where thanks to the division of labour they could generate productivity increases. Investments should then move to domestic trade and finally to foreign trade(see Smith 1776, II.v). The Mercantilist writers were underlying the importance of focusing on foreign trade, but to Smith this was like starting from the tail rather than from the head and it would have damaged the country.

That part of capital which is employed in the carrying trade, is altogether withdrawn from supporting the productive labour of that particular country(Smith 1776, II.v.30). Here 'carrying trade' refers to the physical transfer of goods across borders and not to financial 'carry trade', but there are striking similarities between the two cases, because both activities displace funds from the most productive types of investment. In Book IV Smith directly tackles mercantilist policies, he writes that an invisible hand leads the individuals to employ their capital in domestic industry rather

[24] According to Solow it is "time to rethink the way the credit mechanism mediates between savers and investors and puts credit to productive use" IMF *Finance and Development* of June 2011, p. 51.

than in the foreign one(see Smith 1776, IV.ii.9). This is the only passage in the *Wealth of Nations* in which the invisible hand metaphor appears.

There is *second problem* which worries Smith: *the concentration of market power into the hands of few big players*, the British East India Company being a typical case. This type of alliance characterizes the Mercantilist era and according to Smith it could lead to lower growth and to the modification of the nature of society. This alliance could perpetuate and even enlarge the differences between the different market players, thus increasing imbalances instead of reducing them. It is against this type of association that Smith wrote *The Wealth of Nations*(see Smith 1776, book IV in particular).

Mercantilism should not be easily dismissed, it has been a fundamental aspect of the modern history of Europe and from the sixteen to the eighteen century mercantilist policies have been very effective in determining the economic successes of countries such as England and the Netherlands. Mercantilism has been part of the establishment of the nation states in Europe.

4.2 Modern Mercantilism

Today both stagnating economies and structural 'imbalances' are stimulating neo-mercantilist and protectionist policies; nations fiercely compete on international markets(see also UNCTAD 2014, pp. 17-19). The East Asian countries and China in particular are often regarded as the obvious culprits, mainly because of their undervalued exchange rates.

The management of the exchange rate is only one among the possible policies which can generate a current account surplus. Export subsidies and import duties are the traditional tools, but we also have selective credit systems, tax exemption on reinvested profits, domestic wages/incomes compression, subsidies to Research and Development, products standards etc[25].

With great simplification let us single out two main features of modern Mercantilism.

> ***A first feature of Mercantilism. I****n today's world, where all economies are so much interconnected we can consider as neo-mercantilist all those polices which rely mainly on exports for the sale of the goods and services and which restrain domestic demand*.[26]

[25] The opposition to the free movement of people quite often complements neo-protectionist policies.

[26] This does not necessarily equate with 'export-led growth'. For instance the case of Smith the 'vent for surplus' argument does not imply the compression of domestic demand.

There is a major difference between high and low income countries. In the former domestic consumption represents the largest component of aggregate demand and income per capita is high with decent levels of well being. Because of lower income per capita domestic consumption is not such a large element of domestic demand of developing countries and they need to try to take advantage of foreign demand. However even in poor countries there are serious problems of income distribution.

***A second feature of Mercantilism** is the alliance between big corporations and the state and not only in East Asia. Big international companies may twist the functions and powers of the states to their advantage.*[27]

We must not confuse neo-Mercantilism with the lack of competition on international markets. During the last thirty years there have been very strong newcomers in international markets, the so called emerging economies, in particular in East Asia, and in many sectors there is a fierce competition. This has very little to do with the idea of competition characterized by a multitude of independent producers and by the possibility of new producers to enter the market; this is a *competition among giants*. This is the market situation of several sectors. From automotive to high tech, from capital equipment, to infrastructures, from online activities to international finance there is a strong concentration of productive capacity, also through mergers and acquisition. At the world level these sectors are characterized by *oligopolistic competition*[28].

4.3. The M-M' conundrum

"M-M', money which begets money, such is the description of Capital from the mouth of its first interpreters, the Mercantilists."(Marx 1867 Vol. 1, p. 153).

Few lines later Marx writes that in the case of "interest-bearing capital, the circulation M - C - M' appears abridged. We have its results without intermediary stage, in the form M - M', 'en style

[27] The term 'state' indicates also the international bodies and organizations where individual nation states have different powers and can thus influence their decisions.

[28] Mercantilist policies do not necessarily imply state intervention. In many cases the Mercantilists asked the rulers to refrain from regulating trade, for instance in the case of an old law prohibiting the export of money(see Mun 1623?, pp. 34-36). These does not make them free traders; the real issue is that they were able to influence the state in order either to adopt or not to adopt those policies which were more favourable to national merchants. The overall mercantilist period is more complicated than its traditional representations.

lapidaire' so to say, money that is worth more money, value that is greater than itself'(ibid.).[29] This final line implies M' > M, not a minor point.

Apart from the example of lending at interest the activities of the Merchants were more complicated than what Marx describes. The merchant's gain derived from his ability to *buy cheap and selling dear* and the difference was his *profit upon alienation*. In order to achieve this gain the merchant had to move the goods in space and time, even if he did not physically produce a new product. In eighteenth century France corn had to be transported from the countryside to the cities; in seventeen century England spices had to leave the Indies and to reach the metropolitan area.

With their value chains transnational corporations do something similar and they also do generate new types of goods. In international markets financial investors act like modern mercantilists, who basically gain on the difference between their buying and selling price, but in today finance there is no need either to go through the production processes or to move goods across time and space.

Space has become relevant only in so far as different financial markets are specialized in different types of products. The City of London is home to the largest foreign exchange market; in different financial centres different regulations and laws apply to similar products: to issue a bond in London goes under a different legislation than issuing it in Wall Street.

Time is much more relevant because one must be quick to enter and exit the market. In old Mercantilism the profit upon alienation depended on the quality of the product and on its locations; now profit depends upon the time of buying and of selling any type of financial product.

Financial operations are typically quite fast and they are characterized by ***short-termism***.[30]

In principle bonds are long term, but in the age of Financial Mercantilism the separation between short term and long term flows is blurred. A contract/obligation on a 10 years bond it is long-term but this does not imply that it can be both sold and bought in a continuous way. The search for high yields in emerging markets does not imply that these capital inflows will stay there for the maturity of the bond; in the case of a perceived crisis long term flows can always leave the country. In the 'secondary market' long term bond are commodities.

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[29] These quotations are from the final page of chapter IV -*The General Formula for Capital*- of Part II- *The Transformation of Money into Capital*- of Vol. 1 of *Capital*.

[30] Short-termism is not just a feature of financial operators, but it seems to become a rather pervasive behaviour by corporate manger and some people speak of short-term capitalism(see Mallaby 2015).

In the fifties and sixties my father was buying long-term Italian bonds in order to improve his income during retirement. It was a *de facto* pension scheme with a *long-term contract* between an individual a saver, a consumer, my father, and the state. Today pension funds have the same scope; the aim of the contract is indeed long-term: savings now against consumption capacity in the future. However, in order to guarantee a future income to their customers the pension funds *must* continuously shift savings across different types of investments, in order to yield an annual return at least similar to those of their competitors.[31]

Money cannot rest, it must move endlessly throughout different markets and different financial products in view of a 'profit upon alienation' and of a *positive sign in the balance sheet*.

In financial markets '*products'* are basically *forward contracts*, sort of *bets*, that is to say commitments to buy and to sell at some future time, at a certain price and may be conditional on some events. These are *immaterial commodities*, which can transfer wealth and income and make people either richer or poorer.[32] As in the case of Mun's balance of trade doctrine financial markets are a characterized by a 'zero sum game'. The changes in the distribution of income and wealth take place without going through the production system and not even through trade, transportation and storing as in the old Mercantilist practices.

Let us go back to Marx. In Volume 1 of *Das Capital* he describes the money as 'the medium of circulation' and he uses the script C - M – C to describe the simple circulation of commodities(see Marx 1867, vol. 1, pp. 106, 108, 146). A commodity, C, is exchanged against money, M, in order to buy a different commodity, C. The circulation opens and closes with commodities, specific use values. Marx adds that

"the circuit M - C- M would be absurd and without meaning if the intention were to exchange by these means two equal sums of money"(ibid., vol. 1, p.146).

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[31] Returns play an important role in the decision of portfolio differentiation, but expectations about possible gains/losses is the decisive element in the considerations about buying and selling. The capital gain motive is always there and it supersedes the interest rate component.

[32] Of course the insurance and credit sectors provide specific services to households and to firms, but many types of investment on the derivative markets have to do with the hedging of the risk of one financial product against another. A 'service' is provided but only because of the particular nature of these financial markets. Credit Default Swaps, CDS, are a typical example of a contract whose existence is justified only because in financial markets systemic risk has become very widespread.

A few pages before the quotes which open this section Marx provides what I would say is a good description of the Mercantilist version of circulation: M - C- M', with M' = M + ΔM (see ibid., vol. 1:149).

In the capitalistic mode of production money must be transformed into the commodities, C, which have to used in production. These commodities are transformed into 'labour power', L, and 'other means of production', MP(see ibid., vol. 2, p. 26). The two 'productive forces' are combined in to the production process, P, which gives rise to a new commodity, C'. The sale of this commodity leads to M' and M' - M = ΔM is the surplus value.

Combining different formulas by Marx(see ibid., vol. 2, for instance pp. 34, 63)[33] we can describe the capitalistic circulation of money in the following way:

M – C - (L, MP) ….. P ….C' - M' (1)

The dots refer to the origin of surplus value in the capitalistic mode of production, the main topic of parts III, IV and V of Volume 1 of *Das Capital*.

In the case of Financial Mercantilism the process which gives origin to a surplus value can be described as

M ……. M' (2)

> *In Financial Mercantilism it is not necessary to go through commodity production in order to achieve a surplus value.*

But what are the dots in formula (2)? How can you move from money/capital to more money/ capital? How can money beget more money? How is it possible to have "value that is greater than itself" "without intermediary stage"(ibid. Vol. 1, p. 153)? Some sort of "intermediary stage" it is still there and it is hidden behind the dots.

Capital gains are a typical example of *buying cheap and selling dear* a certain type of financial product. Of course when M' < M there are losses and bankruptcies. Systemic risk is there also for the big players. The argument is not that much different when we consider the entire balance sheet of a financial organization instead of a single operation.[34] Financial operators must always make sure that the price of a financial product in their portfolio does not fall below the buying price, at

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[33] The first three chapters of Vol. 2 are entirely dedicated to illustrate the different 'circuits' of capital, and of how and why it transforms itself into money and commodity.

[34] This was already a problem in seventeenth century Mercantilism; the British East India Company was a joint stock company established in 1601 and from 1612 its shares were traded in the London Stock Exchange.

least for a long period of time, but at the same time in order to make money they need price fluctuations.[35]

Not only international financial markets are characterized by ***price fluctuations****, volatility is needed.*

A higher volatility augments the opportunities of the differences between buying and selling prices. Gavin Jackson underlines the relationship between quantitative easing and in the intensity of volatility, "investors…must sell when prices fall and buy when prices rise, which adds to any market movement"(*Financial Times*, 15, October 2015). How much of these money has ended up into the real economy, either into productive investments or into households' consumption? The additional liquidity can be invested into financial products; because of the low interest rates capital gains become the major source of revenue.

The volatility of the prices of financial products is at the origin of the difference M'-M; volatility is the foundation, or if you wish the necessary condition, for the existence of this difference.
There is still one question: who and how can appropriate the surplus value ΔM?

4.4. The concentration of power

The answer can be found into the second feature of Mercantilism: the concentration/centralization[36] of power. In the age of Financial Mercantilism the overwhelming power of big international investment banks/organizations. As in the case of transnational corporations this situation has nothing to do with free competition. International finance generates *large imbalances in negotiating power among the different market players*. It is thanks to this superior power that the 'modern merchants' can twist the markets to their own interests.
In 2014 the six largest investment banks, four of them American ones, had 49% of the global market share by revenue in the equities and investment banking divisions.
There are at least three ways in which the largest financial organizations can influence the markets:

- asymmetric access to information,
- lack of transparency in many financial products and contracts

[35] Price fluctuations are particularly important in the foreign exchange markets, here transactions are particularly fast.
[36] Centralization is better than concentration, this was suggested by Emiliano Brancaccio.

- some investment opportunities, usually the more lucrative ones, are available only to investors which have large amount of funds. Small is not so beautiful.

The third item is probably the decisive one, of course more investigation is needed.

On one point recent economic events seem to contradict *Mun's rule* according to which the direction of the movements of capital depended on the sign of the current account. The exchange rates do not seem to be regulated by the imbalances in the current account and by the 'flow-specie' mechanism which had already been devised by David Hume(see Vaggi and Groenewegen 2003 pp. 78-80). The evolution of the Euro-dollar exchange rate since 2007 does not seem to endorse this rule. Of course a negative current account does generate opposite movements in the financial account, however, these movements are only a part of the overall flows in this account. In the financial account most capital flows are linked to Foreign Direct and Portfolio Investments rather than to export and imports. Financial flows play also a major role in the foreign exchange markets, FOREX.

The Financial Account is no longer the ancillary brother of the Current Account, it has a life of its own and a leading role in the determination of the exchange rate and of its fluctuations. Moreover the Financial Account plays a major role in the determination of domestic interest rate, mainly through the 'spread'. The Financial Account has now a dominant role; this is the consequence of its opening up, of a system of flexible exchange rate and of the process of financial liberalisation.

This supremacy of the Financial Account leads to a further paradox.

Paradox 4. Modern international finance brings us back to an earlier phase of Mercantilism the so called *monetary balance system*(see Rubin 1929, pp. 26 and 43-46), prevailing in sixteenth century Europe. According to this system money flows were not just related to trade, but depended on the reputation of the national currency: a strong currency resulting in net inflows. This is somehow similar to modern phenomena such as the 'flight to quality' and the fact that a currency which is regarded as a very good store of value can pay zero/negative interest rates.

5. Developing Countries Sovereign Bonds

The low interest rates in High Income economies have led to the search for higher yields with the usual attention to corporate bonds and also to emissions by emerging and developing countries, something we have already seen in the past.[37] The growing interest in bonds of LICs and LMICs includes many countries in Sub Saharan Africa, where sovereign bond issuing has grown to more than 6 billion in 2014 bringing the overall total to more than 18 billion. 14 countries, both commodity exporters and not, have issued bonds most of them denominated in US dollars(see Tyson 2015 I, pp. 3-5 and p. 19 for the countries involved)[38]. All these type of bonds are below investment grade. Most of these emissions are managed by a lead underwriter which usually is a global investment bank(see Tyson 2015 I , p. 6). The debt to GDP ratios of these countries are relatively small in the range of 40%(see Tyson 2015 II, p. 6) much lower than those of the eighties and nineties, before the HIPC and MDRI debt restructuring and debt conversion initiatives.

In Sub Saharan Africa there is also a growing domestic bond market in local currencies which has reached 400 billion USD in 2014, of course interest rates on local currency bonds are higher with respect to those on international bonds(see Tyson 2015 I, p. 12). These interests rates are still relatively low *vis à vis* those experienced in the eighties and nineties, a 7 per cent real growth rate could help to bring the nominal(in dollars) growth rate as high as the interests rates, thus satisfying a financial sustainability condition according to which the debt to GDP ratio does not increase if the nominal growth rate is at least as high as the nominal interest rate(see Vaggi and Prizzon 2014).

However all these countries have negative primary fiscal balances and this contributes to the increase in the public debt to GDP ratio(see Tyson 2015 II, p. 6-7); moreover they also have negative current accounts, which contribute to increase foreign indebtedness. In the case of commodities exporters the value of exports fluctuate with the prices of commodities. These countries are exposed to all three types of risk in the case of foreign debt:

- interest rate risk,
- exchange rate risk,
- liquidity risk.

We could also add country instability and volatility of commodities prices.

Using bonds to finance development goals and investments in poor countries looks safer than other types of portfolio flows and of course than commercial loans. However in case of tensions on

[37] The bond market is by far the largest component of derivatives, with more than 500 trillion dollars.

[38] Tyson 2015 I and II provide an exhaustive analysis of the different types of issuances and of the related problems.

international financial markets there will be a run out of riskier bonds and a the search of safe assets, the so called ‘flight to quality’.[39]

When in early 2014 the Federal Reserve was expected to increase interest rates, the so called “tapering” Ghana, Kenya Tanzania and Ethiopia had to delay or cancel issuances.[40] The Congo case in the prologue is not a unique one, there is for example the much more well known the well known opposition between the Argentinian government and Elliot Management following a sentence by Judge Griesa in a New York court.[41]

The lessons from the debt crises of the eighties have not led to major changes in international financial regulations. A UN document issued on the 21st of January 2015 in preparation of the Addis Conference on FfD of July 2015 and indicates that “debtors and creditors must share the responsibility for preventing and resolving unsustainable debt situations”(see UNDESA-FfD 2015 p. 9). Target 17.4 of the SDGs asks the international community to ‘Assist developing countries in attaining long-term debt sustainability, through coordinated policies aimed at fostering debt financing, debt relief and debt restructuring’(see UN GA 2015).

Unfortunately nothing of that sort is really available. Debt sustainability analyses have progressed a lot since the debt crisis of the eighties[42], however the tools and policies to deal with debt distressed countries are very much the same today as they were thirty years ago. We indicate five problems. yy

1. There is no orderly work out mechanism for debt restructuring, the project of a **Sovereign Debt Restructuring Mechanism SDRM** proposed by Anne Krueger then Deputy Managing Director of IMF in 2003 has not progressed(see UN-ICESDF 2014, pp. 44-45). In 2014 the UN General Assembly passed a resolution asking for a framework for sovereign debt restructuring(see UN Resolution 68/304, 2014).

2. There is no scheme such as that included in **chapter 11** of the US banking regulations, which allows for a temporary freeze on interests and repayments.

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[39] International markets are dominated by the search for capital gains and not only by the pursuit of the higher yields associated with longer maturities and with riskier products(see Moore in *Financial Times* 19, march 2015, p. 22).

[40] A simulations in the 2015 European Report on Development suggests a negative impact of the “tapering” on GDP growth in Sub Saharan Africa of 0.8%(see European Report on Development 2015, p. 139).

[41] For the description of the various phases of the litigation between Argentina and NLM Capital see IMF 2014 Box 1 pp. 8-9.

[42] See for instance the models of the IMF, of the World Bank and of UNCTAD.

3. **Flexible exchange rates** are no shield against sudden deterioration of the country risk perception by financial markets. In the global financial cycle flexible exchange rates cannot insulate emerging economies from financial crises(see Rey 2013). Direct control on capital flows is needed in order to avoid major crises.

4. Following the Asian crisis of the nineties there has been a large accumulation of **reserves** for precautionary reasons[43], but Low and Lower Middle Income countries have very limited reserves. 5. At the time of the Asian crisis of the nineties and of the Latin American debt crisis of 1982 the focus was on the overall amount of the so called **'hot money'**, short term foreign debts, plus the size of current account position, generally a deficit. Reserves were regarded as too small to face short term outflows. Today reserves should be evaluated with respect to the stocks of all types of private, and non-concessional inflows, irrespective of the maturities, perhaps with the exclusion of remittances[44]. According to this criterion long-term bonds must be included among the type of liabilities which could create a situation of financial fragility.[45] Given the dimension of today international financial markets and their volatility the size of reserves should be much higher than just a six months import coverage.[46]

6. Sustainable Financing for Development

Long term financing of the sustainable goals is a very complicated matter because of the economic and financial fragility of many developing countries in particular the most needy ones. We conclude this paper with *three proposals* which can help to improve the sustainability of foreign financing for development.[47]

[43] The UN Preparatory document for Financing for Development conference in Addis 2015 conference mentions systemic risks and financial volatility as the major reasons for the accumulation of reserves by developing countries also in (see UNDESA-FfD 2015, p. 10).

[44]Today no one would think of reserves as a measure of national wealth as at the times of Mercantilism, but it is curious to observe that in the age of growing international finance reserves have in fact grown to very high ratio to GDP.

[45]FDI and remittances do not generate foreign liabilities; however FDI can generate flows of profit repatriation in the following years and this has a negative impact on the Current Account Balance.

[46] For the difficulty in assessing the appropriate amount reserves at the times of financial globalisation see the article by Wheatley and Blitz in *The Financial Times* 19/20 May 2018, p. 13.

[47] "One of the most potent forces in global capitalism is among its least visible. The trillions in speculative capital that slosh between emerging markets arrive and leave without friction. But the

6.1. Entering international financial markets in a gradual way

At some point Low and Lower Middle Income countries will be part of international financial markets, but the problem is when and how. Opening up to international finance will contribute to financial development of these countries, but there is a problem of finding an appropriate sequencing of steps in order to reduce the possibility of severe crises. te Velde 2014 asks for a prudent opening to international capital market[48]. Countries should make use of all available tools and policies to slowly and smoothly bridge the domestic and the international financial markets.

There are some conditions in terms of GDP and export structure which should be achieved before entering international finance. Of course this type of structural transformations need time and in between other policies and tools could be of help.

First, LDCs and LMICs should try to follow an ideal sequencing with respect to finance: first they should try to develop a ***domestic credit and financial system***, based on domestic savings and on lending to local enterprise. In many countries in Sub Saharan Africa credit is very difficult to achieve particularly for Small and Medium Size Enterprises, SMSEs, and interest rates can be very high, in the range of 30%. International public resources, regional development banks and also philanthropy funds could play a big role. Domestic credit and financial markets need time to grow and become more robust before having to deal with the more complicated products of international finance.

Second, a prudent ***management of capital inflows*** and of the financial account in particular, with policies designed to favour the long term inflows and to penalize short term inflows could help(see IMF 2011)[49]. Chile Malaysia are examples of rather successful adoption of these types of policies in the past.

These policies require some sort of **Special and Differential Treatment** for the developing countries which will adopt them. Provisions for special and differential treatment are included in the

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outflows can be devastating, reducing economies to rubble from which some struggle to rebuild."(see Kynge J. *The Financial Times* 19/20 May 2018).

[48] te Velde notices that there is a considerable body of literature which shows that the impact on growth of FDI and portfolio flows is dubious (se te Velde 2014, p. 4).

[49] Eurodad 2014, p.10 too asks for provisions for capital account regulations; see also Tyson 2015 II p. 11.

Agenda 2030, but to put them into operation requires a lot of negotiations; exceptions are not easy to be granted in a period of neo-Mercantilism, not even to low income countries.

Special privileges and policy space for developing countries are part of a general view of what the **global partnership** advocated in SDG 17 should be. This partnership requires a **re-balancing** of the different economic powers of the various stakeholders, particularly in international finance.

A gradual inclusion of low income countries into international financial markets requires the reduction of the distance between advanced and well informed financial operators of the 'North', who have a myriad of opportunities and possibilities and the newcomers from the 'South'. I am not terribly optimistic about the gradual inclusion of the weakest countries into international financial markets. We should recognize the risks of a hasty approach to bond issuing, just because the money is there and investors are in search for higher yields; at some points African sovereign bonds have been oversubscribed. Warnings about the risk of excessive borrowing by African countries come also by Rashid and Stiglitz 2013[50].

6.2. Indexed bonds

Issuing bonds on international financial markets is quite risky for LICs and LMICs also because they have very small domestic financial markets which are not liquid and offer few financial products to "hedge" against different types of risk.[51] A second proposal concern a financial tool which would make life much easier for the developing countries who try to enter the international bond markets: **index linked bonds**. For low income countries the best situation would be that of being able to issue a bond with three types of characteristics:

- it is long-term;
- it is directed to generate capacity and productivity increases;
- it has an element of risk sharing.

The first two features are self-explaining. The third one has to do with the fact that during the transition towards stronger economic and financial structures a crisis could derail the economy from its long term-growth path.

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[50] In an interview to *Finance and Development* Stiglitz notices that "cross-borders flows can be very destabilizing" and that lacking a global regulatory system countries should protect themselves(IMF 2011, p. 51).

[51] In the *Financial Times* of April 25, 2015 Alberto Gallo reminds us that "the general rule in markets, however, is that you can never hedge everything"(p. 20).

Bonds rates could be linked to *macro* magnitudes: typically GDP growth, but also to export performances and to the prices of primary commodities in the case of resource rich countries[52]. Instead of indexing the interest rate one could think of indexing the redemption value of the bonds, as in the case of inflation linked bonds. However for a developing economy it would be much better to index interests payments rather than the capital value. In case of either an external shocks or of the slowing down of the growth rate of the economy the immediate impact will be on the money needed to avoid arrears[53]. Liquidity comes to the fore.

Borenzstein and Mauro maintain that indexed bonds could help to stabilize the debt ratio.[54] There are several advantages with this type of bonds. They transfer part of the risk to the creditors and in general interests payments become pro cyclical: interests are higher when the country performs better and *vice versa*, therefore indexed bonds prove particularly useful in case of an economic slowdown.

Indexed bonds allow for more fiscal space, because less precautionary finance is needed, and they help to stabilize fiscal policy[55]. A study by the Bank of England of the effects of indexed bond for the advanced economies shows that they can also produce significantly positive welfare effects, mainly by reducing default risks(see Barr *et al* 2014).

On the other side of the coin indexed bonds usually have higher borrowing costs then equivalent conventional bonds, so called 'plain vanilla' bonds, with no special rules attached. Therefore when interests rates are relatively low and funds abundant the borrowing countries show little interest in using this type of financing and prefer traditional bonds. Long term economic growth is an essential component of development and indexed bonds fit very well into this scenario; not only they contribute to smooth the business cycle, but they could create a stronger commonality of interest between borrowers and lenders[56].

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[52] There is little role for indexed bonds in ERD 2015; while more attention is dedicated to Diaspora bonds (see ERD 2015, see p. 123).

[53] We must remember that in the case of the debt crisis of the eighties and nineties most of the increase in the debt stock originated because of the inability of countries to service debts and in particular to pay interests.

[54] For a brief literature review of these bonds since the debt crisis of the eighties see Barr *et al*. pp.4-5.

[55] Barr *et al* 2014, find that GDP-linked bonds can facilitate more borrowing because they increase the threshold limits of the debt GDP ratio.

[56] Griffith Jones and Sharma point out to a number of reasons why investors might not like to buy indexed bonds(see Griffith Jones and Sharma 2006).

In the past index-linked bonds have been adopted in the debt restructuring processes of Mexico and Argentina. GDP indexed bonds have come back in fashion in connection with the Greek crisis of 2015 and they have been indicated as a possible tool to restructure the Greek debt (see Goodhart 2015). An essential component of this proposal is that of having very long maturities, up to forty years; this fact will reduce the pressure of debt service. Long maturities are instrumental to try to give the indebted country enough time to improve both its trade composition and its budget. In order to service her foreign debt a country must generate a surplus in the non-interest current account, NICA, (see Vaggi and Prizzon 2014) and quite often also in the primary budget. The improvement of the NICA entails either an increase of exports, not quite an easy task for a LIC, and a decrease of imports; a primary surplus usually requires a contraction of public expenditure and an increase in taxes. Both strategies can be quite painful for economic growth.

Some technical issues need to be faced, for instance one has to decide if interest rates are linked to the variations of either the nominal or the real GDP. In the case of domestic debt linking the rate of interest to the changes in nominal GDP covers the investors from inflation. In the case of foreign debt it could be useful to link the interest rate to a combination of two elements: the inflation rate of the foreign currency in which debts are denominated and the real growth rate of the domestic economy.

Another important issue concerns the authority which should certify the growth rate, the risk being that the national government would underestimate growth in order to pay lower interests on foreign debt. The collaboration of international institutions and of statistical organizations, such as Eurostat for Europe, could help to overcome this difficulty.

Indexed bonds could also be used at the sectors' level and be linked to specific indicators, such as the productivity increases in agriculture and to the performances of some manufacturing sectors. Of course this type of financing implies the existence of a development strategy and of some sort of industrial policy.

These bonds could also be useful at the micro level to finance some firms for instance inside an industrial zone; interest payment could be linked to the performances of the firm. These bonds would still be issued by the a government agency and will have the backing of the country itself but there could be the possibility to convert these bonds into equities.

The fact that the economic sectors which will receive the funds are part of a general and long term strategy of the country should help to limit the interests rates; the bond subscribers know that they invest into a sector which is part of a long term commitment by the country. The government itself has an interest in securing the success and the profitability of the specific sectors and areas which benefit from this type of funds.

Indexed bonds could also be used to finance major infrastructures, in which case it might be difficult to identify a specific indicator to which link the bond returns; it would probably be better to use a more macro type of indicator.

6.3. Separate markets for the bonds of low income countries

The tools and policies seen in the previous parts of this section can greatly help developing countries to manage their bond issuances. However even these instruments cannot avoid a situation in which bonds issued by a Low Income Country are subject to speculation. The Experts on Sustainable Development Financing ask for an enabling international environment that among others "remove the sources of international financial volatility" and strive "to reduce global financial fragility"(UN-ICESDF 2014, p. 40). The document asks for financial markets regulations(see ibid., pp. 27, 34). In *Agenda 2030* Target 10.5 reads: "Improve the regulation and monitoring of global financial markets and institutions and strengthen the implementation of such regulations" (UN-GA 2015, p. 21). Among the SDGs Indicators which have been presented in March 2016 Target 10.5 has one generic indicator 10.5.1 called: "Financial Soundness Indicators"(UN-IAEG SDGs 2016, p. 50). In the December 2015 version of the same document indicator 10.5.1 was: "Adoption of a financial transaction tax (Tobin tax) at the global level". An asterisk pointed out that the final text had not yet been agreed.

This is more or less everything we find in the SDGs about on the regulation of financial markets.[57] Debt sustainability is mentioned in Target 17.4, but Target 8.D of the Millenium Goals was much more articulated on the issue of developing countries debt.

Regulations should try to prevent or at least to penalize short-term speculative investments. However for many Low and Lower Middle Income countries it would be much easier if development finance could take place on dedicated markets.

> *Financing for Development should have its own track, which should be separated from international financial markets.*

[57] SDG 2c advocates "The proper functioning of food and commodity markets and their derivatives"(UN-GA 2015, p. 16).

If Development Finance for LICs and LMICs could have *ad hoc* markets, procedures and regulations that would reduce instability and volatility and the risks of default. In practice this special track for the sovereign bonds of LICs and LMICs aims at a separation of long term investments from speculative activities. Very difficult to achieve, but also extremely necessary.
Let us imagine that developing countries could issue bonds with three characteristics:

- at the time of the issuance special legal clauses make clear the long-run nature of the bonds and indentify the judiciary to be used in case of disputes;
- the issuance is supervised by an international institutions, either a UN agency with experience in debt sustainability such as UNCTAD or the World Bank;
- there is a strict control on the type of investment funds which are allowed to operate on the secondary market.

All these rules could discourage the most speculative buyers, but they might also imply higher spreads on the interest rates on bonds of similar maturity but higher quality. This effect could be mitigated by a **fund** which should be used when the regular servicing of the bonds is at risk because of conditions which are external to the country. These conditions could concern: interest rates increases on international markets; fall in commodity prices; slowing growth in high income and emerging economies.
As long as only the bonds of LICs and of some of the poorest LMICs are entitled to access this development fund the risk of *moral hazard* can be limited. The fund could be located at some International Institutions which could also help on the supervision of the external conditions which determine the activation of the fund. The role of the fund is similar to the World Bank IDA financial window, in the sense that only some well identified countries could take advantage of it. However the funds available are used only if there are specific events, in this way it is a kind of insurance for the buyers of the bonds.
The fund would come into operation in cases which are similar to those requiring the IMF's intervention, when there are liquidity and balance of payments crises. There are however two main differences:

- first, the fund specifically supports long-term borrowing by developing countries, the IMF packages are typically short term;

- second, the indexation makes interests and re-payments contingent on the evolution of the balance of payments and on the specific external conditions which have determined the crisis, an aspect which resembles chapter 11 of the US banking law.

Separate markets for the of bonds by LICs and LMICs resembles the separation between the operations of commercial banks and those of investment banks which was introduced in 1933 with the so called *Glass-Steagall Act* and has been repealed in 1999 by the American Congress with the approval of a new banking law. Following the financial crisis of 2007-2008 the *Dodd–Frank Wall Street Reform and Consumer Protection Act* of July 2010 has introduced many forms of controls and regulations, but it has not recreated that separation. Perhaps the closer that we have got to this separation is with the so called *Volcker rule*, which is trying to prevent United States banks from making speculative investments with the deposits of their customers. The rule has been finally approved on July the 21st of 2015 but its content has been diluted.[58]

Conclusions

A final remark and a doubt. Development is about people and countries' empowerment. Sovereign bonds management requires a good knowledge of the mechanisms of international finance and many developing countries have very *limited financial expertise and debt management capabilities*. Negotiations and consultation on international finance will contribute to capacity and institutional building(see Tyson 2015 II pp. 10-11).

Can we imagine a LIC or even a LMIC to dedicate efforts and human capacities to deal with issues and technicalities such as the RUFO clause(Rights Upon Future Offers)? What about the *Pari passu* clause which guarantees equal treatment between old and new creditors and which created so many problems to Argentina?[59] The IMF has suggested modifications of the *pari passu* clause in order to strengthen the Collective Action Clause, CAC, mechanism and to prevent the possibility for the so

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[58] A more limited financial sector could provide services more effectively directed to the real economy, that is to say a financial sector which is oriented to sustain the real needs of households and firms(see Kay 2015). All the more so in the case of long-term development finance.

[59] This followed from a decision of the US Supreme Court in June 2014 not to hear the Argentina's appeal against a decision by New Your Court in favour of the claim by NML Capital, Ltd., a hedge fund based in the Cayman Islands about being repaid 100 per cent of the original value. A similar problems arose in 2013 with restructuring of Greek debt, in this case most of the bond issuances were under English law.

called ‘holdout creditors’ to block in practice the proper restructuring of sovereign debts(see IMF 2014, pp. 4-5).

Are these the priorities of countries with limited institutional capabilities? Are these the most urgent issues to which the best civil servants of LICs and LMICs should dedicate their efforts? Are these the aims of the 2015 UN Resolution *Transforming our world: the 2030 Agenda for Sustainable Development*? Why not to concentrate governance and administrative capacities on the most pressing Goals, such as poverty, health, education, food security?

Developing countries need time in order to be able to take advantage of the opportunities of international finance. Financial Mercantilism has increased the imbalances between rich and poor countries and between rich and poor people. Developing countries need both special and differential treatment and policy space in order to re-balance this excessive power of rich countries and of financial investment companies.

I am not very optimistic that this special conditions could be achieved, but the risk of renewed financial crisis might be behind the corner.

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